adveq

Benefits of Private Equity for the European Economy

Insights from Macro, Company and Investor Perspective

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Contents

Introduction 3

1 Benefits to the economy 4
1.1 Overcome fragmentation in European markets 4
1.2 Provide entrepreneurs with an exit solution 7
1.3 Increase employment 8
1.4 Champion ESG topics 11

2 Benefits to businesses 13
2.1 Provide capital 13
2.2 Professionalize companies and work environments 14
2.3 Turn managers into owners 15
2.4 Foster growth 16

3 Benefits to investors 18
3.1 Investment outperformance 18
3.2 Lower volatility 19
3.3 Match duration of investments with liabilities 20

Conclusion 21

Introduction

The media informs and reminds us on a daily basis that the European economy is in turmoil. We get bombarded with real time information on government bond spreads, budget deficits, bankruptcies, unemployment etc. Governments, private individuals, and companies alike have to manage increasing struggles, in a market that is stagnating. The difficult situation of the European banking system is having an impact on the real economy, as financing for companies is hard to obtain, tampering growth further.

The financial sector gets a lot of blame for the current situation. Banks were too eager to leverage their balance sheets through providing easy credit. Hedge funds made bets that created huge financial black holes when they opted for the wrong direction, and the biggest Ponzi scheme in history came to light, with smaller schemes being uncovered around the world.

Within this broader context, private equity funds were blamed for buying up companies with a lot of leverage, stripping them of their assets and firing thousands of people, all in order to repay the debt and make a large profit for themselves. But is any of this true? Have these allegations been supported by thorough analyses? We have repeatedly heard the negative associations that a certain number of people have with private equity, and which do not at all match with the reality that we, as specialists, see in the European private equity landscape.

Therefore, in this paper we shed light on the many positive effects private equity has on the European economy. To do so, we have identified three key areas where private equity has measurable benefits: the economy overall, individual companies, and last but not least investors.

1 *Benefits to the economy*

Europe's current economic environment is characterized by a number of difficulties including slow growth, a lack of competitiveness and a high degree of fragmentation in many industry sectors, an ageing workforce, many post-war entrepreneurs retiring and high unemployment. As a consequence in some European countries bankruptcies are at an all-time high.

A common misconception is that private equity has the impact of a locust on the economy. Funds are seen as buying up companies with a lot of leverage, stripping them of their assets, firing people, and not doing anything to benefit the economy and its consumers. In this chapter we show that in reality private equity does a lot for the economy both directly and indirectly.

1.1 *Overcome fragmentation in European markets*

At the core of the European Union ("EU") was the idea of a Single Market, not only for goods, but also for services, capital and workers. Borderless and correspondingly frictionless trade was thought to stimulate competition and trade and to improve efficiency. The EU has come a long way since its initial foundation, and the introduction of the Euro as the common currency was the most important achievement towards greater European integration. Overcoming national borders to fuel growth and job creation and to reinforce Europe's competitiveness are still major goals of the European Commission nearly 20 years after internal border controls between EU countries were abolished. However, while tariffs have been removed and business and tax regulations unified, invisible borders like differences in language and culture cannot be overcome by political regulation. Compared to the US with their long history as a single country and single market, Europe is still a conglomerate of heterogeneous nations.

In the EU today overall exports represent 40% of GDP, and about half of that (21% of GDP) is interstate trade among the EU's 27 members. Although this is a large number, the comparable figure for US interstate trade is still much larger. Further integration between EU countries is possible, and this potential must be tapped to unlock potential for further growth.

Source: OECD, Adveq, 2012

	European Union	United States
GDP in USD trillion at current prices	15.2	14.4
Interstate trade in manufactured goods as share of GDP	21%	38%

Figure 1: Regional market integration in Europe compared to the US

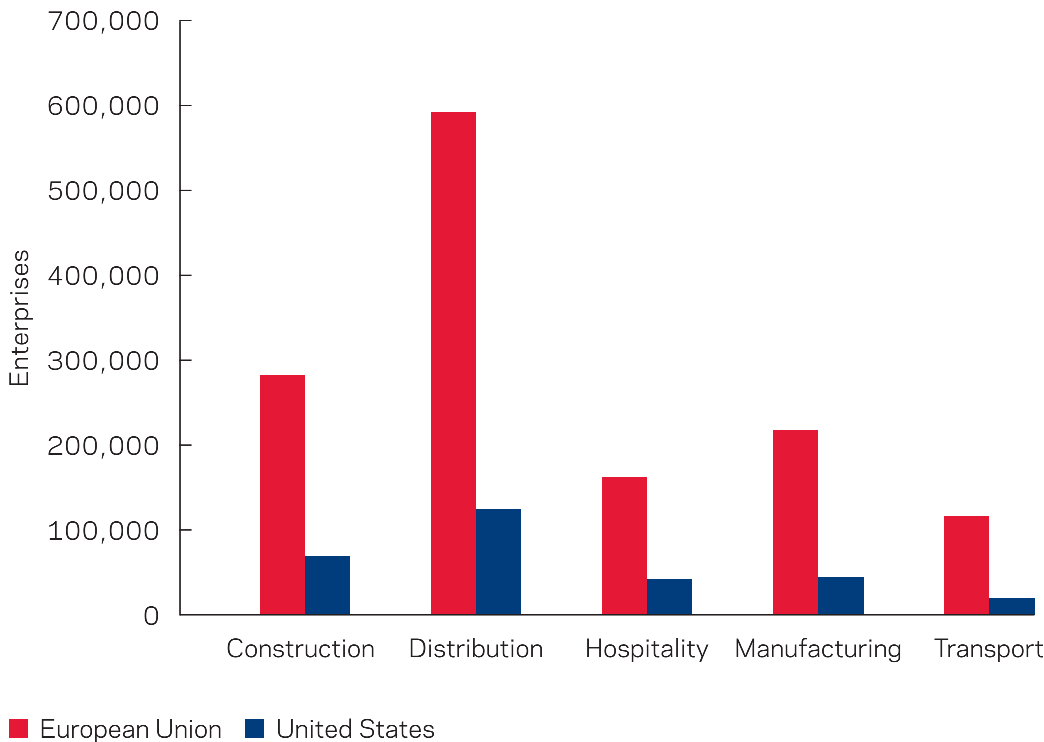
The policies implemented already have made significant progress in consolidating the locally fragmented European economy. In the past, many companies had ambitions to become the largest player within a certain industry only in their home country. Nowadays that thinking has shifted more towards becoming the largest player within a certain industry, regardless of geography. This enlarges the outlook and market opportunities of companies from one to many countries, across all of Europe and even globally. This fundamental shift in thinking works as a catalyst for more consolidation and it allows companies to address much larger markets.

The barriers slowing down consolidation within Europe are also reducing its economic growth and its potential to recover from the current crisis. Integrated markets foster both higher productivity and quality as they increase competition among firms and tend to allocate production based on comparative advantages. Such benefits are not fully realized in Europe, and the corresponding economic potential remains to be fully exploited.

Given this economic situation, what is now the role of private equity? Many companies are initially identified as good businesses which serve only their local home market, often they are local champions. Private equity funds enable them to launch cross-border activities and support them in doing so. Private equity firms can provide such companies with the necessary capital to roll-out and open new branches or subsidiaries abroad. Geographical expansion can also be pursued by intensifying trade connections and increasing exports through new distribution channels. To achieve this, private equity firms introduce companies to a vast network of other businesses and investors across national borders.

In addition to the regional fragmentation described above, Europe's industries are also characterized by horizontal fragmentation. The unconsolidated markets are divided among many small businesses, and the number of companies per industry in Europe far exceeds the equivalent number in the US. Accordingly, the average market share and production per company is significantly smaller. Larger companies can real-

ize economies of scale and produce goods and services at lower average costs, which is beneficial for consumers. Private equity taps into this fragmentation and uses buy-and-build strategies to unlock value.



Source: OECD, Adveq, 2012

Figure 2: Number of enterprises in selected sectors

Through the investment and reorganizational activities described above private equity drives the horizontal as well as vertical consolidation of fragmented industries. Furthermore, when add-on acquisitions are made across national borders this also serves regional consolidation purposes.

Private equity champions both regional as well as horizontal consolidation. Where the effects of policies and regulations have obvious limits, private equity provides a systematic approach to consolidation in the European landscape, with clear benefits for consumers on the continent.

1.2 *Provide entrepreneurs with an exit solution*

Over the last decade a large number of SMEs with an enterprise value of less than EUR 100 million were acquired by private equity funds in Europe from their founding families or from private individuals. This activity is expected to increase, as according to an estimate by the European Commission one third of entrepreneurs in the EU are about to retire. This directly affects over 600,000 companies. To many entrepreneurs who are planning to step down the question of their succession is a major challenge. While the first choice typically is to introduce another family member as a successor, the descendants, if there are any, might not be interested or qualified to take over such a leading function in the family business. The European Commission reports that fewer and fewer generation transfers are taking place within families. Many entrepreneurs are therefore looking for a third party to buy them out.

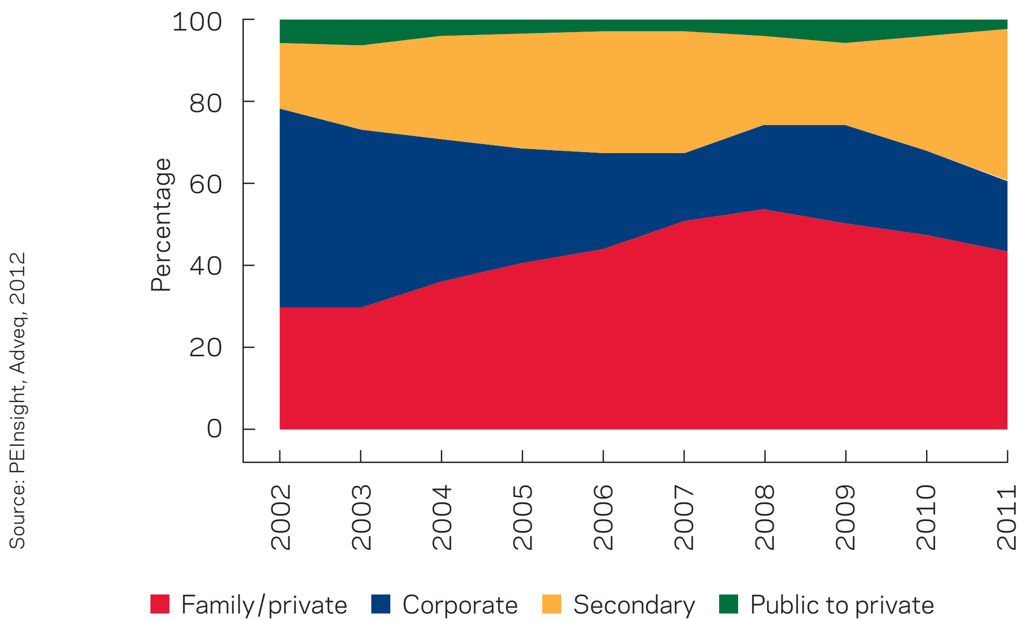


Figure 3: European buyout deals by type of vendor over time

Privately owned businesses are characterized by organizational structures that often do not show the same professionalization as public companies. On one hand, this means that there is room and potential for growth through improvements in efficiency (this topic will be discussed in more detail in chapter two of this paper). On the other hand, it also means that many strategic buyers face difficulties to integrate a private company into their group or larger conglomerate. Consequently, large strategic buyers are often reluctant to buy privately owned businesses from the founders.

If the company is a solid business, employees could be interested in taking over through a management buyout, but usually cannot finance a buyout with their own means. And even if they could, they would likely still lack the know-how to professionalize the business on their own.

In all these cases, a management buyout that is supported by a private equity fund provides a good solution for privately owned businesses. Private equity fund managers build bridges with entrepreneurs, by helping incumbent management, providing strategic input, professionalizing the company, and providing security of financing. Where necessary, a private equity company can also source qualified management from its extensive network (this is known as a management buy-in). The private equity fund manager guides and grows the company from a family business to a professionalized SME that is ready and attractive for a full take-over by management or a third party such as a large strategic buyer.

SMEs are generally considered to be the backbone of the European economy and securing their future on a going concern is vital to Europe's recovery, and private equity is leading in the efforts to do just that.

1.3 *Increase employment*

Europe is facing an economic crisis with an unprecedented impact not only on government finances but also on employment. In southern European countries unemployment rates have climbed to numbers similar to those seen during the great depression of the 1930s. In some of these countries, almost every fourth person is currently unemployed, and government austerity programs might further aggravate the situation. For example, half of the people aged 25 and below are unemployed in Spain, and the figure has been increasing rather than decreasing since austerity began.

Private equity plays a significant role in increasing employment. When pursuing organic growth private equity backed companies will need additional personnel to support this growth. When pursuing roll-out strategies new subsidiaries and outlets might be set up, and all new functions will need to be staffed. Similarly when performing a carve-out of a division from a larger company, the administrative and service units that used to be staffed by the parent company will have to be built up and staffed, transforming the carved out division into a fully operational independent business.

In order to gather quantitative evidence on the influence private equity has on employment of portfolio companies, in 2012 Adveq carried out a survey among its European private equity fund managers. In total, Adveq surveyed 34 private equity buyout and turnaround fund managers in which it has invested with since the year 2000. These fund managers represented a total of 460 European portfolio companies.

The analysis compared the number of employees at the time of investment to the current number or the number at the time of exit (if the company meanwhile has left the portfolio). The aggregated numbers indicate that the surveyed private equity funds have increased staff at their companies by an average of 26%. This is equivalent to a total increase of more than 142,000 employees in the portfolio.

The survey also found that both the biggest percentage and absolute increase occurred in the small buyout segment (private equity funds up to EUR 500 million in size), with the underlying companies owned by these funds boosting employment by 33% (more than 52,000). While showing a slightly lower increase of 23% in the workforce, midsize and large buyout funds both still achieved to significantly outperform the growth rates of the labor market. Funds operating in the turnaround segment of the market – those who buy troubled companies on the edge of bankruptcy – were the only ones to report negative development in employment numbers at their underlying portfolio companies. However, these numbers should be seen in context: bankruptcy threatens the loss of all jobs at a company; therefore, private equity ownership could be seen to have saved, on average, 87% of jobs at troubled companies.

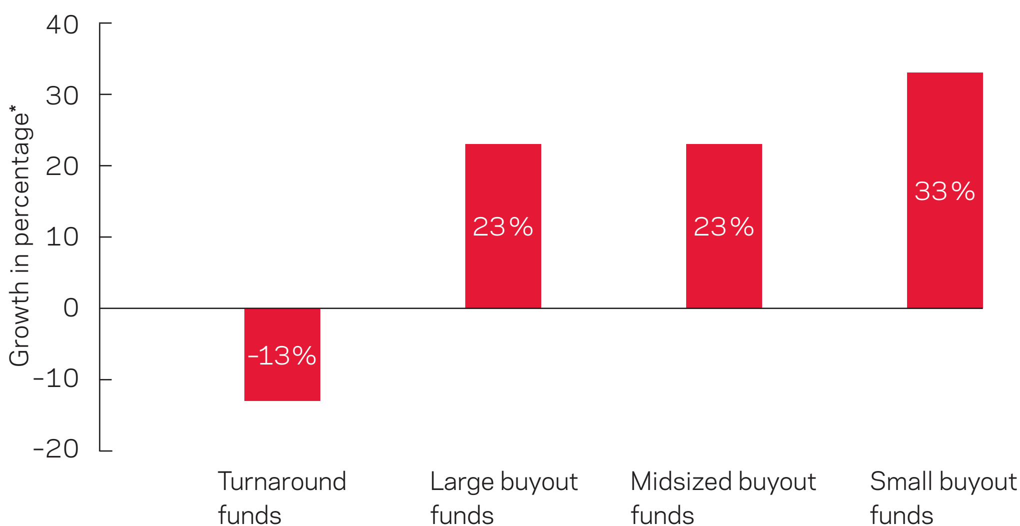


Figure 4: Total growth in number of employees by fund type

The positive impact of private equity on employment is not only visible in different types of funds, but also over time. So, when analysing portfolio companies based on the year in which private equity funds made their initial investment, investments from any given year show positive employment dynamics throughout the last decade.

* The growth rates refer to the overall growth in employment in these companies from the year of initial investment until Q1 2012 or at exit.

Even the relatively young investments from 2007 to 2011 showed significant growth in employment despite the current crisis. For example, company investments made in 2009, the year of the global financial crisis, showed increased employment of 19%. Furthermore, the surveyed private equity-owned companies increased staff numbers in all regions across Europe. Striking among those numbers is the 19% increase in employment in southern European businesses, a development that is very different from the overall labour market in that region.

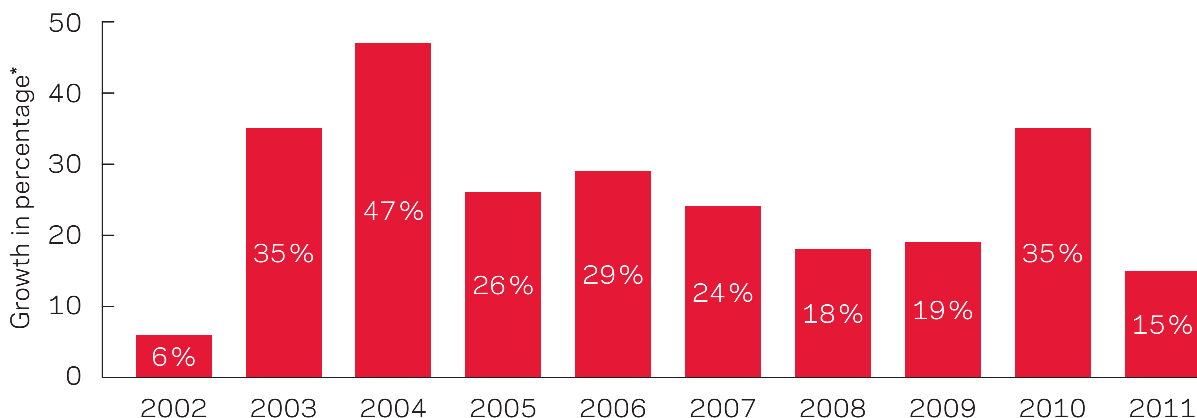


Figure 5: Total growth in number of employees by year of initial investment

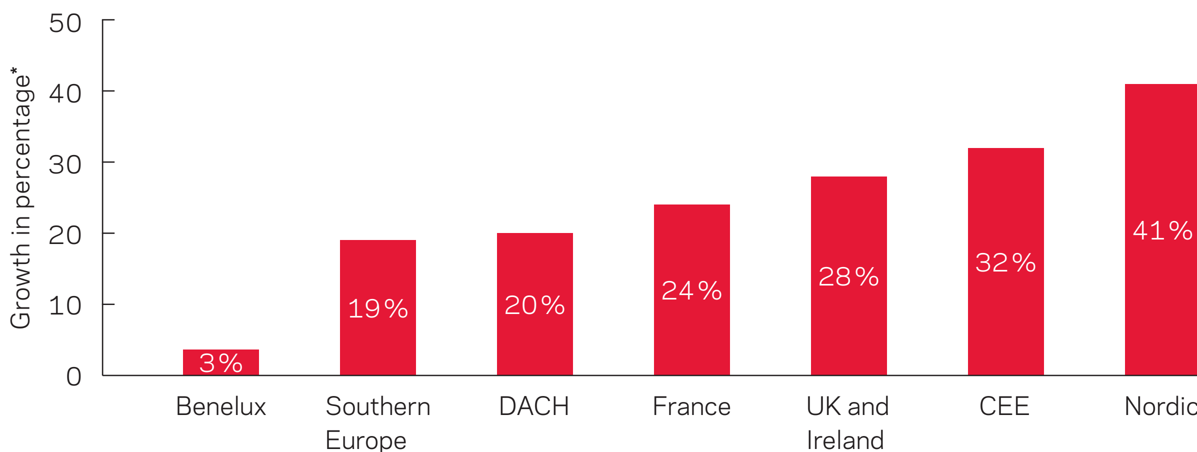


Figure 6: Total growth in number of employees by geography**

* The growth rates refer to the overall growth in employment in these companies from the year of initial investment until Q1 2012 or at exit.

** Southern Europe includes Italy, Portugal, Spain and other southern European countries; DACH includes Austria, Germany and Switzerland; Central and Eastern Europe includes the Czech Republic, Russia, and other eastern European countries; Nordic includes Denmark, Finland, Norway and Sweden.

1.4 *Champion ESG topics*

Due to emerging challenges such as climate change, population growth and constraints of natural resources, the last ten years have seen increased attention from specialists and the broader public on environmental, social and corporate governance (ESG). Approaches have been made by politicians and consumers to promote ESG awareness in businesses.

Customers and financiers have the closest interaction with firms, thus encouraging them to overview their policies through the incorporation of environmental, social, and governance standards in investments has also become part of private equity managers' agenda. Key drivers of this development are concerns from institutional investors as well as the financial and reputational risk which portfolio companies might face. Furthermore, fund managers are increasingly aware that they can use ESG levers to maximize value creation in their investments. According to a survey carried out by the WWF, there are two main corporate value drivers deriving from ESG, namely:

- **Revenue and profitability improvement** The most obvious benefits are those of eco-efficient production. Actively managing a company's use of natural resources by ensuing quality and sustainability of materials used, as well as reducing CO2 emissions, lowers operational costs and increases efficiency. Also human capital may be enhanced when implementing ESG principles. The introduction of corporate social responsibility (CSR) policies tends to reduce personnel turnover and recruitment costs. In addition to these efficiency effects, firms may also gain a competitive advantage through ESG. Revenue increases through ESG awareness are driven by brand enhancement, product development and differentiation. In turn a firm can increase prices for their goods and services. A company may also increase customer loyalty or gain access to further markets and customer segments. Through these effects a sound approach to ESG issues enhances both earnings and margins.

- **Risk mitigation** Adhering to ESG standards is also an instrument of risk mitigation. For example, when social and governance principles are followed, corporate governance is subject to continuous improvement. Paying close attention to structures and allocation of authorities significantly reduces internal operational risk. The related reduction in exposure to losses due to human error not only benefits the company from the financial side but more importantly by limiting reputational risks. The same holds true for encouraging environmentally and socially sound procurement and production.

Adherence to ESG principles is particularly important for long-term oriented activity and therefore promotes sustainability. An organization that engages with sustainability and ESG issues is perceived to be more intrinsically valuable, as it shows a commitment to the long-term development and standing of the business.

Active management of ESG issues does not only promote financial value within the company but also creates ethical benefits to a firm's clients, employees, and the communities in which it operates. While it remains challenging to measure all indirect benefits of ESG initiatives, a visible implication is that companies with strong policies and practice in ESG compliance are much easier to sell. A survey by PwC found that trade buyers are likely to put a discount on enterprise valuation for poor ESG performance.

Private equity is a highly active and long-term oriented ownership model. As such, it is able to make significant, sizable and rapid changes to companies. Therefore, the private equity industry offers one of the most effective approaches for responsible investors to push the implementation of ESG principles in companies. In private equity ESG principles are not only used for negative screening and as such excluding certain sectors, but ESG standards are also used for positive screening and therefore implementing and improving ESG guidelines at portfolio companies. The closeness and active involvement of private equity firms enables them to bring ESG principles on the corporate agenda of their portfolio companies and support their active implementation in the daily business. The long term perspective of private equity investments allows full implementation of ESG measures and to return a profit to investors through the resulting increase in enterprise value. The concentrated ownership in the private equity model streamlines the implementation of ESG guidelines. The comparatively high ownership fragmentation of public companies makes it much more difficult for their investors to push through the necessary change.

Private equity has grasped ESG as an opportunity both to reduce the risk of investments and to increase returns from them. The asset class drives the implementation of ESG principles on all levels from investors, through fund managers, and into portfolio companies.

2 *Benefits to businesses*

The global financial crisis and the subsequent sovereign debt crisis have changed the landscape of the European economy and its financial sector. Banks are looking at cleaning up their balance sheets and are getting rid of bad loans, while improving their capital ratios. As a consequence, the banks have significantly reduced their lending to businesses, and have also increased the costs for such loans. This is hurting in particular SMEs, as their access to bank financing has been hurt the most. This has clear negative consequences for the real economy.

The European economy also has a very diverse landscape of industries that are performing at different paces. Some industries are growing, whereas others are flat or declining. That said, even within industries that perform poorly overall, there are sub-sectors that show significant growth. In this chapter we see how private equity fund managers provide financing to companies, professionalize the business, and create value through growth.

2.1 *Provide capital*

Although central banks are swamping financial markets with liquidity, hoping that market conditions will get better, many companies suffer from a lack of access to funds. Commercial banks, which are still recovering from the financial crisis, are forced to improve their capitalization. Consequently, despite record low interest rates, small firms frequently experience a shortage of capital due to a lack of lending from banks, which restricts their growth and limits their possibilities to realize market opportunities.

A number of private equity managers therefore targets companies that find it hard to access capital. Fund managers actively research markets and closely follow interesting companies in order to be well positioned when capital is needed. They have also built industry networks that allow executives, owners and trade sellers to approach them. Providing equity rather than debt, private equity fund managers do not charge companies high interest rates but typically demand a controlling ownership stake or a minority ownership with control rights. As private equity funds provide more equity, the focus on debt is often reduced, thus leading to lower debt levels in private equity owned companies compared to those observed in the public market.

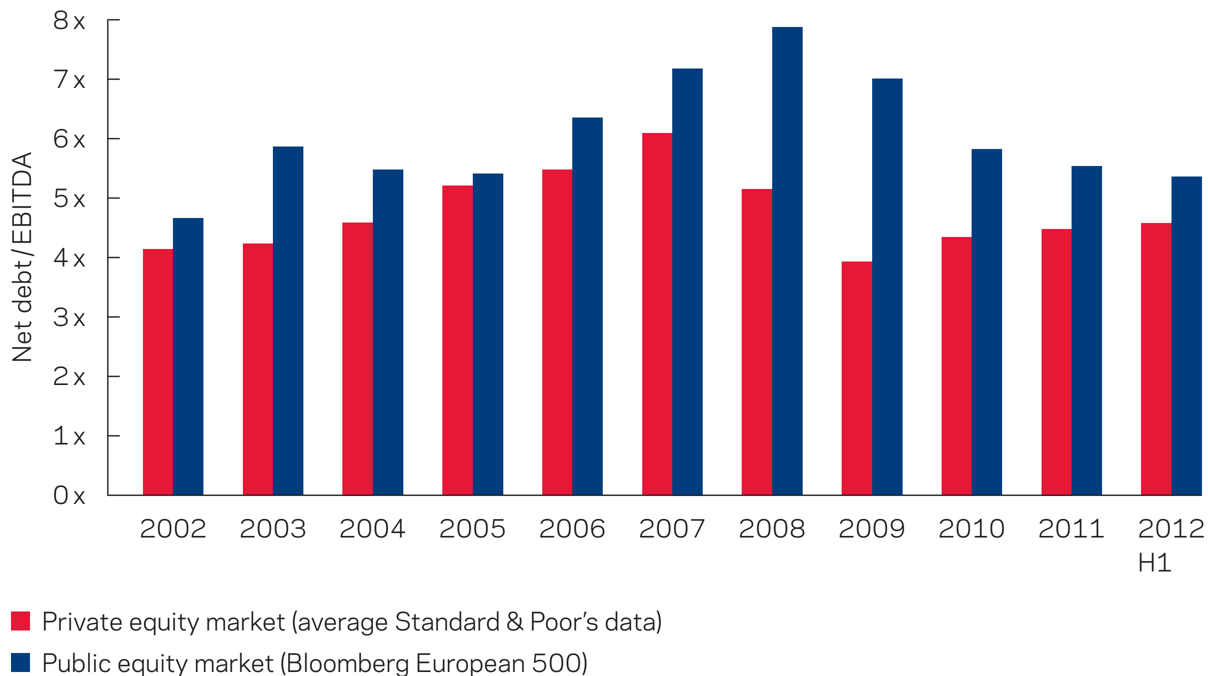


Figure 7: Net debt multiples of private equity compared to public equity in Europe

2.2 *Professionalize companies and work environments*

Many private companies do not show the same level of business professionalization as public companies. Listed companies operate in a highly regulated environment, which enforces them to comply with stringent requirements. Private companies are only subject to an annual review.

Private equity investments are based on a fund manager's view of untapped potential within a company and the perceived room for corporate growth. Their strategies to realize this potential in order to increase corporate value depend on the nature of the business. Top-line strategies – which typically focus on organic growth, consolidation of an industry or geographical expansion – are usually accompanied by measures aimed at increasing efficiency, such as outlined below.

- **Organizational issues** In SMEs, functions are not always filled efficiently and along managers' competencies. Often crucial functions like CFO, Chairman, or Head of Controlling/IT/Sales/HR etc. are not fully established. There is typically a large scope to enhance those functions and roles. The need for reorganization in such SMEs prevents many trade buyers from taking over these firms. In addition, mismanaged or badly integrated departments in larger companies may show underperformance and potential for improvement which private equity fund managers may perceive as an

opportunity. When taking over SMEs or departments of larger companies, private equity firms focus on adjusting and improving organizational structures. They use their know-how and experience to adjust the hierarchy within the business and allocate responsibilities and authorities to support growth of the companies.

- **Commercial aspects** In many cases, commercial aspects provide opportunities for active private equity fund managers. Business processes like reporting or controlling may have been neglected or may need to be newly established for small companies and for corporate carve-outs. Typically enterprise resource planning (ERP) systems and key performance indicators (KPIs) are introduced to enable better tracking of business performance and development. This often helps to detect further activities that are not operated at full efficiency. Procurement, sales or production processes are reviewed thoroughly to increase efficiency and to introduce lean production methods. Also net working capital measures are implemented to free up cash that can be put to work in more profitable manners.

As a result of private equity fund managers' efforts, portfolio companies can reach a higher degree of business professionalization, increase their sales, and ultimately prepare the company for a buyout by managers or employees or a takeover by trade buyers.

2.3 Turn managers into owners

While private equity fund managers have the know-how to reorganize, professionalize, and grow companies, they still need to rely on skilled management to lead the day-to-day running of a business. However, small companies often find it difficult to attract qualified managers. Generally, holding a senior position in a small company does not offer the same prestige or incentives compared to holding a senior position in a large, well known company. This can be overcome by giving managers a share of the upside in the company they work for.

Private equity has taken charge of this opportunity to attract top management not solely by offering interesting and challenging jobs at the portfolio companies but through the implementation of an equity culture. Usually this is not exclusive to the CEO or other top executives, but is applied to a wider group of management in the company. A 2009 Stanford University research paper on managerial incentives in private equity found that the top 20 to 80 managers in an acquired company typically obtain significant equity. The level of management participation depends on the type of business; the involvement is higher in service companies than in manufacturing businesses. The study also found that a CEO of a private equity portfolio company

holds approximately double the number of shares compared to CEOs of public companies. A central characteristic of these participation programs is that the executives are not provided with the equity shares as a form of compensation. The managers are required to actually purchase the shares, thereby contributing capital to the company. It is this investment into the business that takes managers from being agents to managers behaving as owners.

This participation has two main benefits. Firstly, it is in the interest of investors as it creates incentives based on equity value creation and, as a consequence improves the alignment of interest between investors, fund managers and employees significantly . Secondly, it is highly attractive for the management who can participate in the up-valuation as the private equity investment successfully provides for growth and ultimately value creation. This culture of participation in corporate success lures top managers to take on positions in private equity backed SMEs.

2.4 *Foster growth*

As outlined above, private equity funds provide capital, improve structures and processes and incentivize managers in order to achieve growth. However, growth strategies pursued by different private equity fund managers vary and usually depend on aspects such as the industry and the stage of a specific business. Firm roll-outs, geographical expansions and new distribution channels are used for companies with inherent growth potential, and capital is invested to enhance and expand production facilities. The growing workload in these companies may also require more staff, leading to company growth not only in KPI numbers but also in headcount (as described earlier).

Private equity combines increasing sales with improved efficiency enhancing margins, which drives earnings growth in the portfolio companies. This growth empirically exceeds the comparable performance of a public company. Figure 8 on the growth rates in Adveq's underlying portfolio companies shows clear outperformance of private equity owned companies compared to public market companies.

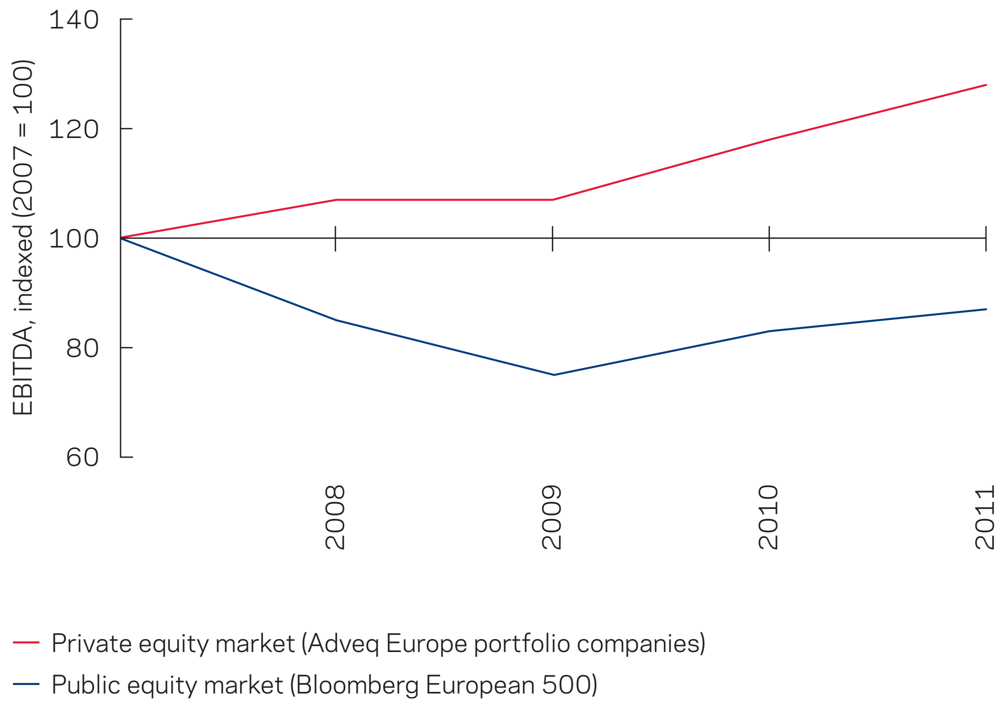


Figure 8: Earnings development of private equity compared to public equity in Europe

3 Benefits to investors

Given the poor performance of public markets, it has been difficult for investors to generate good returns in Europe over the past decade on their equity exposure. Private equity has often been underweight or even remained untouched by investors because they did not like the illiquid nature of the asset class.

However, private equity represents a great opportunity for institutional investors also in the current environment. As lending by banks to SMEs is decreasing, the opportunities for private equity investors increase. The balance of capital supply and demand in the market looks to remain favorable to investors for the foreseeable future. As we will see in this chapter, key benefits for investors in private equity are its outperformance, lower volatility compared to public markets, and matching durations of liabilities and assets.

3.1 Investment outperformance

An investor's ultimate goal is to generate returns on the capital invested in promising opportunities. After repeat stock market crashes, the traditional public equity exposure that many investors have, has reported unattractive performance over the recent years.

Compared to other asset classes, private equity is less liquid. Therefore investors expect a premium, and this premium has historically been earned. The active involvement that private equity funds seek in their investments has provided investors with returns that have clearly outperformed public markets in the long term. For example, while the Euro Stoxx 50 generated an annual return of -2.2% from 2002 to 2011, European private equity buyouts featured annual returns of 11.6%. This performance, strong both on a relative and absolute basis, is driven by skilled private equity managers growing businesses. Outperformance by private equity holds true also when comparing performance of private and public equity over both a shorter timeframe (ie. 5 years), and over a longer timeframe (ie. 15 years).

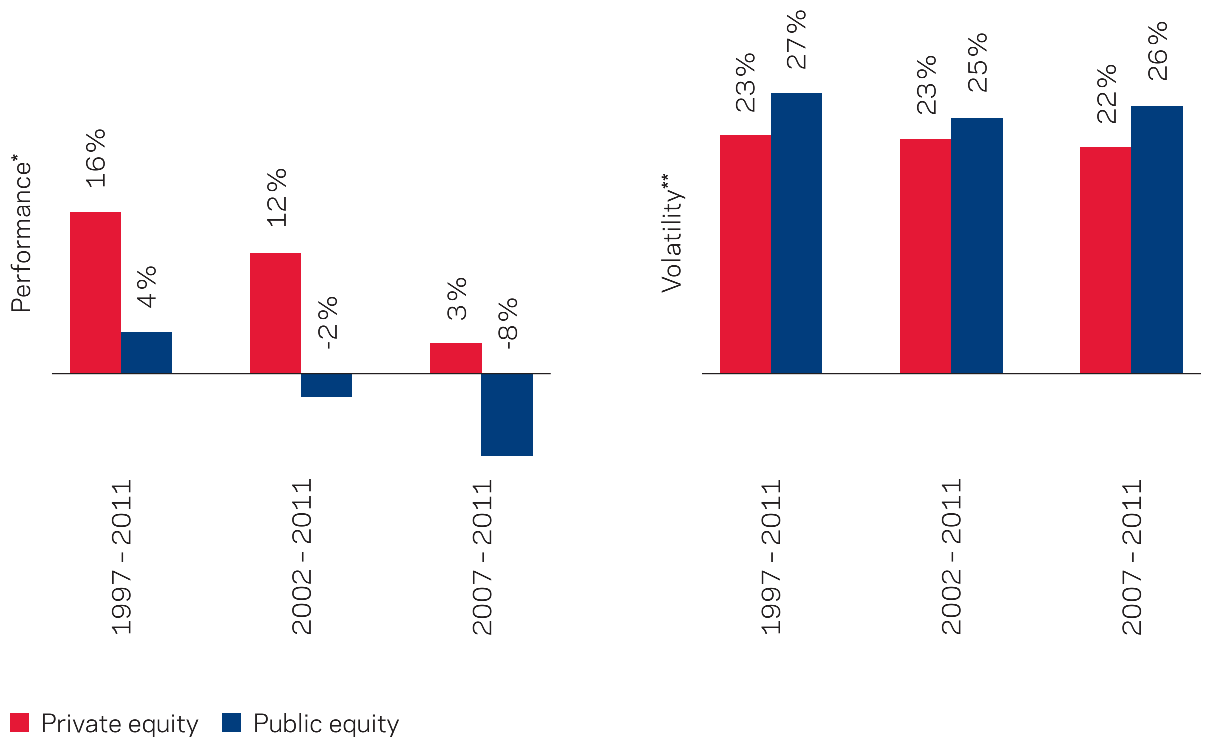


Figure 9: Performance and volatility of European buyouts compared to public equity over different periods of time

3.2 *Lower volatility*

Since the bursting of the housing market in the US and the subsequent global financial crisis, stock markets have been highly volatile, regionally as well as globally, driven by macroeconomic events. The sudden, drastic changes in share valuations are often decoupled from the fundamental company value and rather follow overall financial market sentiment.

Private equity as an alternative investment class offers a less volatile investment opportunity. The investment performance is driven by business valuations which are based on fundamentals such as earnings or sales and which may also take into account a company's potential for further growth. As private equity investments are relatively illiquid and rarely traded, their valuations are based on detailed quarterly assessments of their business performance and less on temporary market sentiment.

* Geometric mean of annual periodic IRRs for private equity; geometric mean of annual total returns for public equity.

** Standard deviation of annual periodic IRRs for private equity; standard deviation of annual total returns for public equity.

Consequently, as displayed in figure 9, private equity provides investors with more stable valuations than public equity, as they are not driven by daily fluctuations in the financial markets but by more tangible corporate developments.

3.3 Match duration of investments with liabilities

Private equity has a long term perspective when it comes to investments. For investors, the different investment horizons are targeted based on liquidity needs. The duration of private equity investments match the longer term needs of investors. As an asset class, private equity differentiates itself clearly from other alternative investment classes, such as hedge funds, which are typically structured for much shorter durations. Private equity has a clear vision on how to generate returns, and how to do so consistently. Furthermore, private equity matches the long term orientation of pension funds that are not in need of liquid or short term assets but focus their investments on sustainable and steady performance.

Conclusion

The European economy has come a long way in the last 20 years. However, over the last five years it has faced many challenges. Although big steps have been made in terms of integration and cooperation, many differences between countries and regulatory frameworks still exist. The banking industry has suffered from the global financial crisis and the sovereign debt crisis which has crippled the availability of financing, particularly to SMEs. All this has affected the real economy.

Although private equity is not always portrayed in a positive manner, the asset class has grown from humble origins to an established investment option in Europe. As we have shown in this paper, private equity as an asset class has clear and demonstrable benefits for the European economy. This can be seen from the perspective of the economy in general, from the perspective of individual companies going through a phase of private equity ownership, and from the perspective of investors in private equity funds.

- The asset class exploits inefficiencies that are present within the European economy, such as regional, horizontal, and vertical fragmentation. Private equity focuses on value creation, which is mainly driven by real growth. Furthermore, entrepreneurs who are facing succession issues can turn to private equity to secure the future of their business. As demonstrated in a survey of Adveq's own portfolio managers, private equity clearly shows a positive impact on employment, a finding which was confirmed for most private equity segments, throughout the past decade and even during the peak of the financial crisis. Also, environmental, social, and governance (ESG) topics have in the recent years moved to the forefront of an effective investment strategy, and private equity is the ideal catalyst to implement a sustainable culture in companies.

- Privately owned companies, and in particular SMEs, are often less professionally managed compared to their larger and publicly listed peers. Private equity fund managers enable their portfolio companies to improve and become much more efficient and professional. While SMEs frequently face challenges getting bank financing, especially in the current environment, private equity can step in to fill that gap. And as top quality management is often not incentivized to work for SMEs, the private equity model overcomes this by implementing an equity culture where a large part of management and employees can participate financially in the long-term success of the company. The overall efforts by the private equity industry help companies to achieve above average growth, without using leverage as a main driver to achieve such growth.

- Finally, private equity has clear benefits for investors. Although the asset class is, by nature, less liquid than public equity, its outperformance more than compensates with the illiquidity premium historically being earned. Furthermore, private equity is less volatile than public markets, and the duration of the investments match the longer term liabilities of many institutional investors.

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